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No. 97-1491

In The

Supreme Court of the United States

October Term, 1997

THE ESTATE OF DAVID J. BRAUNSTEIN and ROSEMARIE BRAUNSTEIN, *et al.*,

Petitioners,

vs.

MERRILL LYNCH, PIERCE, FENNER & SMITH INCORPORATED, *et al.*,

Respondents.

On Petition for Writ of Certiorari to the Court of Appeals of the State of New York

RESPONDENTS' BRIEF IN OPPOSITION

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QUESTION PRESENTED

Whether the federal regulatory scheme permitting securities broker-dealers to use customer free credit balances in their business for specified purposes would be compromised by state common law requirements that broker-dealers pay any economic benefits from such use directly to their customers, where Congress and the SEC have recognized the existence and utility of retention by broker-dealers of benefits from such use.

RULE 29.6 STATEMENT

The following are the parent companies or nonwholly owned subsidiaries of respondents:

The parent of respondent Merrill Lynch, Pierce, Fenner & Smith, Inc. is Merrill Lynch & Co., Inc. The only non-wholly owned subsidiary of Merrill Lynch, Pierce, Fenner & Smith, Inc. is Merrill Lynch Professional Clearing Corp.

Neither respondent Prudential Securities, Inc. nor its ultimate parent, The Prudential Insurance Company of America, a mutual insurance company, nor any subsidiary or affiliate has issued shares to the public.

Respondent Smith Barney Shearson, Inc. is now Smith Barney, Inc. The direct parent of Smith Barney, Inc. is Salomon Smith Barney Holdings Inc., and the ultimate parent of Smith Barney Inc. is Travelers Group Inc. Smith Barney, Inc. does not have any non-wholly-owned subsidiaries.

Respondents Kemper Securities Group, Inc. and Kemper Securities, Inc. are now EVEREN Securities, Inc. The parent of EVEREN Securities, Inc. is EVEREN Capital Corporation. EVEREN Securities, Inc. does not have any non-wholly-owned subsidiaries.

The ultimate parent of respondent Dean Witter Reynolds, Inc. is Morgan Stanley Dean Witter & Co. The only non-wholly owned subsidiary of Dean Witter Reynolds, Inc. is SPS Transaction Services, Inc.

Respondent Alex, Brown & Sons, Inc. is now BT Alex. Brown Incorporated. The parents of BT Alex. Brown Incorporated are Bankers Trust New York Corporation and BT

Alex. Brown Holdings Incorporated. The only non-wholly owned subsidiary of BT Alex. Brown Incorporated is Alex. Brown Investment Management Incorporated.

The ultimate parent of respondent Bear, Stearns Securities Corp. is The Bear Stearns Companies. Bear, Stearns Securities Corp. does not have any non-wholly-owned subsidiaries.

The ultimate parent of respondent Charles Schwab & Co., Inc. is The Charles Schwab Corporation. Charles Schwab & Co., Inc. does not have any non-wholly-owned subsidiaries.

Respondent Kidder Peabody & Co., Incorporated is now a wholly-owned subsidiary of Paine Webber Group, Inc.

The only parent, subsidiary, or affiliate of respondent PaineWebber, Inc. that is publicly held is Paine Webber Group, Inc.

Respondent Lehman Brothers, Inc. ("Lehman") has the following parent: Lehman Brothers Holdings, Inc. ("Holdings"). Holdings is a public company. No other Lehman affiliates have offered shares or other obligations to the public.

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Respondents, eleven leading securities broker-dealers, respectfully request that this Court deny the petition for a writ of certiorari.

OPINIONS BELOW

The opinions of the Supreme Court of the State of New York, County of New York (the "trial court") dismissing petitioners' initial complaint for lack of particularity and denying respondents' motion to dismiss the amended complaint are published, respectively, at N.Y.L.J., Jun. 22, 1995, at 29, col. 4, and N.Y.L.J., May 16, 1996, at 27, col. 4. (Petitioners' Appendix ("Pet. App.") A38, A154). The opinion of the trial court denying class certification is published at N.Y.L.J., Oct. 2, 1996, at 22, col. 5. (Respondent's Appendix ("Resp. App.") 1a). The opinion of the Supreme Court of the State of New York, Appellate Division, First Department ("Appellate Division") is reported at 238 A.D. 2d 242, 657 N.Y.S. 2d 12. (Pet. App. A34). The Decision and Order of the New York Court of Appeals ("New York Court of Appeals") dismissing the appeal as of right is reported at 90 N.Y. 2d 934, 686 N.E. 2d 1366, 664 N.Y.S. 2d 271. (Pet. App. A26). The Decision and Order of the New York Court of Appeals denying the motion for leave to appeal is reported at 91 N.Y. 2d 803. (Pet. App. A31).

STATEMENT OF THE CASE

At issue in this action is which law, federal or state, regulates the obligations of securities broker-dealers to their customers in handling cash — referred to as "free credit balances" — arising in customers' brokerage accounts.[1] The federal regulatory

1. Free credit balances are defined in Rule 15c3-3 of the Securities Exchange Act of 1934 ("Exchange Act") as "liabilities of a broker or dealer to customers which are subject to immediate cash (Cont'd)

scheme expressly permits broker-dealers to use customers' free credit balances in the operation of specific areas of their businesses, subject to certain disclosure requirements. Both the Securities and Exchange Commission ("SEC") and Congress have recognized that securities industry practice generally is not to make payments to customers for the use of such balances, and that customers benefit from such use. The SEC also has rejected specific proposals that free credit balances be treated as trust funds, and has instead declared that the payment of interest to customers on free credit balances is a matter of contract, not a matter of right, between the individual customer and the broker-dealer as creditor and debtor. Petitioners challenge the conclusion of the Appellate Division that this carefully designed federal scheme would be "severely compromised" by, and therefore preempts, application of state law to require payments to customers for the use of free credit balances. (Pet. App. A37).

Petitioners are or were brokerage customers of respondents, eleven leading registered securities broker-dealers.[2] Petitioners purport to bring this action on behalf of a massive, unmanageable class.[3] Petitioners claim, without setting forth

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(Cont'd)
payment to customers on demand, whether resulting from sales of securities, dividends, interest, deposits or otherwise . . . ." Exchange Act Rule 15c3-3(a)(8), 17 C.F.R. § 240.15c3-3(a)(8) (1996).

2. Not all petitioners are customers of all respondents.

3. The class was defined as:

> All persons or entities in the United States who have, or have had accounts with one or more of the respondents in which they have had free credit balances which existed overnight or longer from which the respondents

(Cont'd)

any particulars, that respondents "create" and then "use their customers' free credit balances, generate an economic benefit from this use and retain such economic benefit as their own." (Pet. App. A52 at ¶ 3). Petitioners also allege that respondents have "delayed the transfer of the Plaintiffs' and Class members' free credit balances, enabling them to further retain and use these free credit balances for their own profit." (*Id.*). Based on these generalized allegations, the amended complaint asserts state common law claims for breach of fiduciary duty and unjust enrichment. (Pet. App. A78-81 at ¶¶ 29-41). Petitioners seek an accounting and restitution for any gain or economic benefit derived from respondents' use of the free credit balances existing overnight or longer in petitioners' accounts and allegedly retained by respondents. (Pet. App. A51 at ¶ 1). In addition, petitioners seek a temporary and permanent injunction enjoining respondents from continuing the practices complained of, as well as a declaratory judgment that respondents' acts are illegal. (Pet. App. A81-82).

A. The Proceedings in the New York Courts

Respondents moved to dismiss the initial complaint in this action on the grounds that, *inter alia*, petitioners' claims were

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(Cont'd)

> have received economic benefit for which the respondents have not properly accounted to the petitioners.

(Pet. App. A60 at ¶ 11.). The trial court refused to certify the class because, *inter alia*, it found that petitioners "have failed to show that a *common* 'method and procedure' was adopted by defendants whereby free credit balances were unnecessarily created, delayed, or retained" and "have not made it at all clear who they seek to represent." Resp. App. 13a, 18a (emphasis in original).

preempted by federal law.[4] The trial court denied respondents' federal law grounds for dismissal but dismissed the complaint with leave to replead on the grounds that petitioners failed adequately to plead causes of action for breach of fiduciary duty and unjust enrichment, pursuant to Section 3013 and Rule 3016(b)[5] of the New York Civil Practice Law and Rules ("CPLR"). (Pet. App. A154). Petitioners then filed an amended complaint. (Pet. App. A150). Respondents again moved to dismiss; the trial court denied the motion. (Pet. App. A38). Defendants appealed both orders. While the appeal was pending, the trial court denied class certification. (Resp. App. 1a).

The Appellate Division reversed the trial court and dismissed the action as preempted by federal law.[6] The court relied primarily on a recent decision of the New York Court of Appeals, a decision with respect to which this Court denied certiorari. *Guice v. Charles Schwab & Co.*, 89 N.Y. 2d 31, 674 N.E. 2d 282, 651 N.Y.S. 2d 352 (1996), *cert. denied*, 117 S. Ct. 1250 (1997). Following the Appellate Division's dismissal,

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4. Prior to the filing of this action, petitioners filed a predecessor action in Arizona Superior Court. The case was stayed on forum non conveniens grounds; that stay is still in effect.

5. CPLR Rule 3016(b) requires that breaches of trust be pleaded with particularity.

6. The petition characterizes the Appellate Division's opinion as "incorrectly focusing on the permissive use of free credit balances (an issue that was never contested by petitioners) rather than the fruits of such usage." Pet. 2-3. In fact, that court described petitioners' claims as "seek[ing] an accounting and restitution of *any benefit received* by defendants *from use* of free credit balances belonging to the class members." (Pet. App. A36) (emphasis added). Thus, the Appellate Division plainly recognized petitioners' purported distinction between "use" and "benefits from use" and found it unpersuasive.

petitioners sought review by appeal as of right to the New York Court of Appeals. That court dismissed the appeal.[7] (Pet. App. A26). Petitioners then moved for leave to appeal to the New York Court of Appeals, citing the "national importance" of the issues presented. *See* Motion Of Plaintiffs-Appellants For Leave To Appeal To The Court Of Appeals, at 8, in the New York Court of Appeals, Index No. 111667/94. That motion was denied. (Pet. App. A31). Petitioners then filed the instant petition.

REASONS FOR DENYING THE WRIT

This Court should deny the writ because: (i) the court below correctly applied this Court's preemption jurisprudence to the federal regulatory scheme governing free credit balances; (ii) there is substantial uniformity in the lower courts that Section 28(a) of the Securities and Exchange Act of 1934 ("Exchange Act") does not foreclose preemption of state common law claims that conflict with the Exchange Act and SEC regulations; and (iii) the facts of this litigation are unique and unlikely to recur.

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7. Petitioners represent that "the New York Court of Appeals dismissed the petitioners [sic] appeal as of right on constitutional grounds because — in that court's view — there was *no* constitutional issue." Pet. 3 (emphasis in original). This is a misstatement of the New York Court of Appeals' finding, which was that "no ***substantial*** constitutional question is directly involved." Pet. App. A29 (emphasis added). In light of the New York Court of Appeals' decision less than a year earlier in *Guice* and the similarity of the issues presented in this case, that court properly found that petitioners' grounds for objection to the Appellate Division's finding of preemption were not substantial. *See* Weinstein-Korn-Miller, *New York Civil Practice: CPLR*, ¶ 5601.09, at 56-46 (Matthew Bender 1996) ("Regardless of what the magnitude of a constitutional question might otherwise be, the question is not substantial once the Court [of Appeals] has authoritatively resolved it in a recent decision.").

I.

THE NEW YORK COURTS PROPERLY APPLIED THIS COURT'S PREEMPTION DECISIONS TO THE INTERACTION BETWEEN THE FEDERAL REGULATORY SCHEME GOVERNING FREE CREDIT BALANCES AND PETITIONERS' STATE COMMON LAW CLAIMS.

The petition primarily raises the question of the proper application of this Court's preemption decisions to the interaction of petitioners' state common law claims with the particular federal regulatory scheme at issue. Examination of the regulatory background demonstrates that, under well-settled law, petitioners' claims are preempted.

A. Federal Regulation of Free Credit Balances

1. "Free Credit Balances"

Free credit balances are cash balances in customer brokerage accounts that are payable to customers on demand and that result from securities transactions, deposits of cash including sales of securities, or receipt of dividends or interest. *See* Exchange Act Rule 15c3-3(a)(8), 17 C.F.R. § 240.15c3-3(a)(8) (1996). Because securities accounts are transaction accounts, free credit balances held by a broker-dealer at any given time will represent a fluctuating and complex mass of large and small receipts and disbursements relating to securities transactions and positions.

2. Broker-Dealers' Treatment of Free Credit Balances Is Pervasively Regulated

The handling of customers' free credit balances by securities broker-dealers has been subject to intensive and longstanding oversight and supervision by Congress and the SEC.

a. *Congress*

Congress has determined that the "national public interest" requires a "*national* market system" and a "*national* system for clearance and settlement of securities transactions." Exchange Act, Section 2, 15 U.S.C.A § 78(b) (West 1981) (emphasis supplied). As an integral part of the national regulation of the securities markets, Congress has expressly mandated that the SEC "shall prescribe" rules and regulations regarding "the carrying *and use* of customers' deposits or credit balances." Exchange Act, Section 15(c)(3), 15 U.S.C.A. § 78o(c)(3) (West Supp. 1996) (emphasis supplied). Indeed, Congress has long been aware that free credit balances, which are funds protected by the Securities Investor Protection Act, "may be and are used by broker-dealers to maintain positions in securities, to finance margin purchases of other customers, and to operate their businesses generally" and has recognized that "[o]nly rarely, is interest on [free credit balances] paid by the broker to the customer." H. Rep. No. 91-1613, 91st Cong., 2d Sess. (1970), *reprinted in* 1970 U.S.C.C.A.N. 5254, 5255-56. *See also Matter of Atkeison*, 446 F. Supp. 844, 849 (M.D. Tenn. 1977) (quoting House Report and other Congressional statements).

b. *SEC*

The SEC has complied with the mandate of Congress to regulate broker-dealers' use of customer free credit balances in brokerage accounts by adopting Rules 15c3-2 and 15c3-3 under the Exchange Act. *See* 17 C.F.R. §§ 240.15c3-2 and 240.15c3-3(e) (1996). Rule 15c3-2, adopted in 1964, permits a broker-dealer to use free credit balances in connection with the operation of its business, as long as the broker-dealer informs customers at least quarterly regarding the amount of free credit balances carried for each customer's account, that such funds are *not segregated* and *may be used* in the operation of the

business of the broker-dealer, and that such funds are payable on demand. *See* Exchange Act Rule 15c3-2, 17 C.F.R. § 240.15c3-2 (1996). The SEC rejected a version of this Rule that would have required broker-dealers to disclose whether or not interest would be paid on free credit balances. *Adoption of Rule 15c3-2*, Exchange Act Release No. 34-7325, [1961-1964 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,000 at 81,668 (May 27, 1964) ("*Adoption of Rule 15c3-2*").

Rule 15c3-3, adopted in 1972, pursuant to Congress's explicit mandate, expressly authorizes broker-dealers to use free credit balances to finance customer-related activities such as the clearance and settlement of margin transactions, short sales, and failed deliveries. *See* Exchange Act Rule 15c3-3(e), 17 C.F.R. 240.15c3-3(e) (1996) and Exhibit A thereto. In proposing this Rule, the SEC explained that it had engaged in a careful balancing of competing concerns:

> The purpose behind the proposed rules is to afford as complete protection as possible to customers . . . without depriving the industry of *necessary* and *legitimate* means to carry on customer oriented business.

Proposal to Adopt Rules 15c3-3 and 15c3-4 and to Amend Rules 8c-1 and 15c2-1, Exchange Act Release No. 34-9388, 1971 WL 16389, at *6 (Nov. 8, 1971) ("*First Proposal of Rule 15c3-3*") (emphasis supplied). The SEC intended Rule 15c3-3 to be "comprehensive" and uniform in its application. *See Adoption of Rule 15c3-3*, Exchange Act Release No. 34-9856, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,083 at 82,346 (Nov. 13, 1972).

Notwithstanding the fiduciary aura with which petitioners seek to imbue their account relationships with their broker-

dealers, the SEC has explicitly rejected the notion that a broker-dealer acts as a trustee for customer free credit balances.[8] Rather, the SEC has stated that the relationship of broker-dealers to customers with respect to free credit balances is that of *debtor-creditor*. *See Adoption of Rule 15c3-2*, ¶ 77,000 at 81,668; *Proposed Rule 15c3-2*, Exchange Act Release No. 34-7266, [1961-1964 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,978 at 81,622 (Mar. 12, 1964) ("*Proposal of Rule 15c3-2*") (the relationship between a broker-dealer and its customer with respect to free credit balances "is that of creditor-debtor"). The SEC has rejected the characterization of free credit balances as "trust funds," explaining that it "sought to avoid freezing the liquid resources of the securities industry or depriving it of business opportunities in areas, such as margin lending, where it has traditionally played a significant and constructive role." *Proposal to Adopt Rule 15c3-3*, No. 34-9622, [1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,801 at 81,729-30 (May 31, 1972) ("*Second Proposal of Rule 15c3-3*").

The SEC has expressly stated that the payment of interest on customers' free credit balances is a matter of contract to be agreed upon between a broker-dealer and its customer, rather than a matter of right. Indeed, it is illegal for broker-dealers to pay interest on free credit balances created for the purpose of earning interest. *See Notice to Broker-Dealers Concerning Interest-Bearing Free Credit Balances*, Exchange Act Release No. 34-18262, 4 Fed. Sec. L. Rep. (CCH) ¶ 25,134B at

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8. As originally proposed, Rule 15c3-3 would have required the segregation of all customer funds in "a 'Special Account for the Exclusive Benefit of Customers' ('the Special Account') *in the nature of a trust fund*," as well as requiring a reserve account. *See First Proposal of Rule 15c3-3*, 1971 WL 16389, at *2-3 (emphasis added). As adopted, the Rule dropped the Special Account requirement and complete segregation in favor of a reserve account requirement.

18,327-3 (Nov. 17, 1981) ("Notice *Concerning Interest*"); *Hon. Frank Horton*, SEC No-Action Letter, 1983 SEC No-Act. LEXIS 2027 (Mar. 12, 1983); *In re Newman (Ann)*, SEC No-Action Letter, [1970-71 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,177 at 80,545 (May 6, 1971) (declining to require payment of interest on free credit balances inasmuch as such matters are "governed by contract between the parties") ("*Newman*"); New York Stock Exchange, Inc. ("NYSE") Rule 436, NYSE Guide (CCH) ¶ 2436 (1990).

Long before the SEC's adoption of Rule 15c3-3, the role of free credit balances in enabling broker-dealers to provide services to customers had already been recognized by the SEC in its Special Study of 1963. *SEC, Report of Special Study of Securities Markets*, H. Doc. No. 95, 88th Cong., 1st Sess., Pt. 1, at 393-94 (1963) ("Special Study").[9] In the Special Study, the SEC noted that "[f]ree credit balances come into being in the normal course of the broker-dealers' business" and that "[f]rom the point of view of the broker-dealer, free credit balances represent a *desirable source* of funds since generally they can be *used interest-free* [footnote omitted]." *Id.* at 393, 394-95 (emphasis supplied). The SEC concluded that "rigidly denying broker-dealers the use of such balances would cause *serious dislocation* to a significant part of the securities industry" and that any such denial "would have to be considered in the

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9. The Special Study analyzed the effectiveness of the federal securities laws and regulations and suggested specific recommendations to strengthen public confidence in the securities markets. *See* Special Study at 415. Petitioners take out of context passages from the Special Study, which "recognized the importance of the rules and regulations of *various state and federal* regulatory agencies . . . in providing rights and protection for customers . . ." Pet. 10, n.5 (emphasis in original); Special Study, Ch. III.D.1.d. at 391. This part of the study, however, pertained solely to margin agreements — not to free credit balances. *Id.*

light of its *effect upon the services now provided* by the industry." *Id.* at 401 (emphasis supplied). Such services, which may vary from one firm to another, can include financing and settling customer margin trades and short sales, settling sales where customers fail to deliver the securities sold, maintaining custody of customers' securities, receiving and crediting dividends and interest paid on such securities, and others too numerous to name.

Thus, the SEC, which is charged by Congress with the protection of investors, has extensively regulated the use of free credit balances by broker-dealers. The resulting federal scheme is a carefully balanced one that should not be upset.

B. The New York Courts Properly Applied This Court's Preemption Standards

1. This Court Has Consistently Held That State Laws That Conflict With The Purposes and Objectives of Federal Regulation Are Preempted

The Supremacy Clause preempts petitioners' state law causes of action because they would frustrate the federal regulation of broker-dealer activities in connection with customer free credit balances. *See* U.S. Const., art. VI, cl. 2. Federal preemption of state law can occur in three circumstances: where Congress explicitly preempts state law ("express preemption"), where preemption is implied because Congress has occupied the entire field of law ("field preemption"), and where preemption arises from a conflict between federal and state law ("conflict preemption"). *See Capital Cities Cable Inc. v. Crisp*, 467 U.S. 691, 699 (1984). For there to be conflict preemption, there need not be directly opposing duties between federal and state law that would render compliance with both a literal impossibility. *See Schneidewind v. ANR Pipeline Co.*,

485 U.S. 293, 310 (1988) (preemption may be found even where "collision between the state and federal regulation may not be an inevitable consequence.") (citation omitted); *Securities Indus. Ass'n v. Connolly*, 883 F.2d 1114, 1118 (1st Cir. 1989) ("a direct, facial contradiction between state and federal law is not necessary to catalyze an 'actual[ ] conflict', . . .") (citation omitted), *cert. denied*, 495 U.S. 956 (1990). Instead, an irreconcilable conflict sufficient to give rise to conflict preemption will exist if state law undermines the federal regulatory scheme or when state law "stan[ds] as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress" as manifested in the language, structure, and underlying goals of the federal statute at issue. *See Barnett Bank v. Nelson*, 517 U.S. 25, 31 (1996) (citation omitted). Preemption under such circumstances is well-established. *See International Paper Co. v. Ouellete*, 479 U.S. 481, 491-92 (1987); *Hillsborough Co., Florida v. Automated Med. Labs, Inc.*, 471 U.S. 707, 713 (1985).[10]

The doctrine of conflict preemption relates not only to acts of Congress but also to regulations promulgated by federal agencies such as the SEC. *See, e.g., Capital Cities*, 467 U.S. at 699 (Federal Communications Commission). Moreover, state common law, as well as statutes, may be preempted. *See CSX Transportation, Inc. v. Easterwood*, 507 U.S. 658, 675 (1993) (Secretary of Transportation's regulations preempted plaintiff's common law negligence action); *Fidelity Fed. Sav. & Loan Ass'n v. de la Cuesta*, 458 U.S. 141, 154-55, 159 (1982) (Federal Home Loan Bank Board's due-on-sale regulation

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10. While petitioners make much of caselaw referring to a presumption against preemption of matters of state exercise of local police powers, such as with respect to health and safety, the same concerns are not implicated in state regulation of the national operations of securities firms and their place in the national system for clearance and settlement of securities transactions.

preempted California common law doctrine limiting due-on-sale provisions).

2. Petitioners' State Common Law Claims Conflict With The Purposes and Objectives of The Federal Regulatory Scheme

The SEC, in regulating broker-dealers' use of customer free credit balances, has sanctioned the use of free credit balances by broker-dealers, recognizing that such use does not usually involve payment of interest to the customer but nevertheless has substantial overall benefits for customers and the securities markets. *See Special Study*, at 393-95, 401; *Notice Concerning Interest*, ¶ 25,1348 at 18,327-3; *First Proposal of Rule 15c3-3*, 1971 WL 16389, at *6; *Newman*, ¶ 78,177, at 80,545. The detailed regulation of free credit balances in Rules 15c3-2 and 15c3-3 contains no provision for compensation to customers of any imputed income to broker-dealers from the use of free credit balances; nor does it require segregation of customer funds, as one would expect in a fiduciary relationship. Rather, the regulatory approach relies on specific disclosure requirements, including disclosures that the free credit balances will not be segregated, unlike fiduciary funds, and that the customer's broker-dealer can use these balances in its business. Petitioners do not allege that respondents violated these disclosure requirements.

Instead, petitioners complain that respondents fail to disclose that they "will obtain and retain economic benefits" from the use of customer free credit balances; do not advise customers "of the nature and extent of the economic benefit actually derived" and do not "describe, report or identify what free credit balances are nor the amount of the Plaintiffs' or Class members' free credit balances on hand at any time." (Pet. App. A65-66 at ¶¶ 25-26) (emphasis supplied). Petitioners thus seek additional

disclosure beyond the SEC-mandated disclosure of Rule 15c3-2 — a Rule from which the SEC deliberately deleted any requirement that payment or non-payment of interest be disclosed. The disclosure plaintiffs seek is, therefore, inconsistent with, and thus preempted by, federal law.

This Court found in *Barnett Bank* that state law may not forbid what federal law purposefully permits. In that case, this Court ruled that a federal statute permitting national banks to sell insurance preempts state law to the contrary, stating:

> In this case we must ask whether or not the Federal and State Statutes are in "irreconcilable conflict." The two statutes do not impose directly conflicting duties on national banks — as they would, for example, if the federal law said, "you must sell insurance," while the state law said, "you may not." Nonetheless, *the Federal Statute authorizes national banks to engage in activities that the State Statute expressly forbids. Thus, the State's prohibition of those activities would seem to "stand as an obstacle to the accomplishment" of one of the Federal Statute's purposes. . . .*

Id. at 31 (emphasis supplied). *Accord Capital Cities*, 467 U.S. at 699 (striking state law forbidding cable companies from broadcasting federally-permitted liquor advertisements). This Court's reasoning in *Barnett Bank* is applicable to this action. Since being given authority by Congress to regulate the treatment of customer free credit balances more than two decades ago, the SEC has not only permitted the present treatment by broker-dealers of free credit balances, it has specified, in Rule 15c3-2, the disclosure that must be made to the customer with respect to these balances. As discussed above, the SEC has chosen not to require that all or part of any benefit obtained from broker-

dealers' use of customer free credit balances inure to those customers. Indeed, the SEC deliberately rejected the treatment of free credit balances as trust funds. *See Second Proposal of Rule 15c3-3*, ¶ 78,801 at 81,729-30; *Adoption of Rule 15c3-2*, ¶ 77,000 at 81,668 (May 27, 1964); *Proposal of Rule 15c3-2*, ¶ 76,978 at 81,622. This regulatory choice may not be overridden by state common law. *See Edgar v. MITE Corp.*, 457 U.S. 624, 635 (1982) (plurality found conflict preemption where federal requirements like those of state law had been considered but rejected).

Further, application of state law to the treatment of free credit balances by broker-dealers would unduly encroach upon the balance of interests struck by Congress and the SEC in regulating that practice. *See Edgar*, 457 U.S. at 634, 639 (plurality found that state anti-takeover statute upset congressional balancing of management's and shareholders' interests by favoring the former). The SEC has attempted to provide, so much as possible, "virtually complete customer protection" while not "depriving the industry of necessary and legitimate means to carry on customer oriented business." *First Proposal of Rule 15c3-3*, 1971 WL 16389, at *6.

Petitioners cite *Freightliner Corp. v. Myrick*, 514 U.S. 280, 282 (1995), for the proposition that "the absence of a federal standard cannot implicitly extinguish state common law." Pet. 13. In *Freightliner*, the defendants claimed that certain regulations of the National Highway Traffic Safety Administration ("NHTSA") concerning air brakes preempted the petitioners' state law negligent design claims. The Ninth Circuit, however, had previously enjoined NHTSA from enforcing those regulations, citing the agency's failure to show sufficient evidence to justify its regulations. *See Paccar, Inc. v. NHTSA*, 573 F.2d 632, 640-43 (9th Cir.), *cert. denied*, 439 U.S. 862 (1978). Accordingly, this Court found that the lack

of federal regulation did not result from any affirmative decision by the agency not to regulate, but from a federal court order. *Id.* at 286-87. Unlike the NHTSA in *Freightliner*, however, the SEC has extensively studied and specifically rejected the requirement that broker-dealers treat free credit balances as trust funds. Accordingly, the SEC's decision is a carefully considered federal standard that extinguishes all inconsistent state common law causes of action.

Even if characterized solely as a decision not to regulate, a decision by a federal agency to take a "hands-off" approach does not serve as a signal to a state that it may regulate. *See Ray v. Atlantic Richfield Co.*, 435 U.S. 151, 178 (1987) (" 'where failure of . . . federal officials affirmatively to exercise their full authority takes on the character of a ruling that no such regulation is appropriate or approved pursuant to the policy of the statute,' [s]tates are not permitted to use their police power to enact such a regulation.") (quotation and citation omitted); *Carstensen v. Brunswick Corp.*, 49 F.3d 430, 431 (8th Cir.) ("The decision not to regulate has the same preemptive force as a decision to regulate."), *cert. denied*, 516 U.S. 866 (1995); *Pokorny v. Ford Motor Co.*, 902 F.2d 1116, 1123 (3d Cir.) (finding preemption of state defective design claim where less restrictive federal automobile safety regulation was intended to preserve industry flexibility and customer choice), *cert. denied*, 498 U.S. 853 (1990).[11]

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11. Petitioners also cite this Court's recent decision in *Medtronic v. Lohr*, 518 U.S. 470, 116 S. Ct. 2240 (1996), for the proposition that "substantially identical state and federal standards of behavior or performance [do not] preempt state causes of action." Pet. 13. Petitioners concede, however, that the obligations they seek to impose are not "substantially identical" to the federal scheme. *Id.* Moreover, the decision in *Medtronic* turned upon the meaning of a statutory term — "requirements" — that is not at issue here. *See Medtronic*, 518 U.S. at ___, 116 S. Ct. at 2255-59.

In sum, by asking that respondents' treatment of free credit balances be subjected to greater obligations under state law than under federal regulation, petitioners would have state courts eviscerate the SEC's carefully drawn regulatory scheme. The New York courts properly found that the Supremacy Clause does not permit this.[12]

II.

THERE IS NO CONFLICT BETWEEN THE LEGISLATIVE PURPOSE OF SECTION 28(a) OF THE EXCHANGE ACT AND THE LOWER COURTS' FINDING THAT PETITIONERS' CLAIMS ARE PREEMPTED.

Petitioners rely upon the "Savings Clause" of the Exchange Act, Section 28(a), to posit a "conflict" that needs to be resolved by this Court. They argue that the lower courts in this action "failed to consider" that Section 28(a) provides that "the Exchange Act's rights and remedies are 'in addition to any and all other rights and remedies that may exist a law or in equity.' " Pet. 11. In fact, the Section 28(a) argument was presented to the Appellate Division in extensive briefing and at oral argument, and rejected.[13] The New York Court of Appeals then

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12. For purposes of opposing the petition for a writ of certiorari, respondents will not fully address the alternative grounds raised below for dismissal. As argued below, however, the complaint should also be dismissed under the Commerce Clause of the Constitution and pursuant to the principles of primary jurisdiction. Moreover, as discussed, *infra*, Point III, there is no merit to petitioners' state law claim.

13. *See* Brief For Defendants-Appellants, at 25-26, n.15, Brief For Plaintiffs-Respondents, at 14-16; and Reply Brief For Defendants-Appellants, at 14-16, all in the Appellate Division, Index No. 111667/94.

refused to grant leave to appeal that decision. (Pet. App. A31). Moreover, as petitioners fail to mention, numerous courts have addressed this issue in recent years, primarily in the context of challenges to the practice known as "payment for order flow." In every such action in which the merits have been addressed, the courts have ultimately found in favor of preemption.

In any event, petitioners' argument is without merit. Conflict preemption has been found by this Court despite the existence of savings clauses in federal statutes. For example, this Court held that Vermont's common law cause of action for nuisance against a water pollution source in New York was preempted by the Clean Water Act, despite the Act's savings clause, which provided that "nothing. . . shall restrict any right which any person . . . may have under any . . . common law . . . to seek any other relief." *International Paper Co. v. Ouellette*, 479 U.S. 481 (1987). This Court found that permitting the law of a state in which the pollution source was not located to impose a "separate discharge standard . . . would be a serious interference with the achievement of the 'full purposes and objectives of Congress.' " *Ouellette*, 479 U.S. at 493. This Court concluded that "[i]t is unlikely — to say the least — that Congress intended to establish such a chaotic regulatory structure." *Id.* at 497. *See also Michigan Canners & Freezers Ass'n v. Agricultural Marketing and Bargaining Bd.*, 467 U.S. 461 (1984) (Michigan statute preempted by Agricultural Fair Practices Act because of conflict between the Michigan statute and that Act, despite a savings clause similar to Section 28(a)).

Similarly, a plurality of this Court has determined that Section 28(a) did not foreclose conflict preemption but "left the determination [of preemption] . . . to the courts." *Edgar*, 457 U.S. at 631. Thus, as the New York Court of Appeals found in *Guice*, Section 28(a) negates a finding of "field" preemption, but it does not alter the conflict preemption analysis.

Guice, 89 N.Y. 2d at 49-50, 674 N.E. 2d at 291-92, 652 N.Y.S. 2d at 361-62. The Appellate Division properly recognized that such reasoning applies with equal force to petitioners' argument that Section 28(a) expressly preserves their claims. After considering this argument and the New York Court of Appeals' unanimous holding in *Guice*, the Appellate Division decided that this action was controlled by *Guice*. (Pet. App. A37).

Petitioners do not challenge the holding of *Guice*. Rather, petitioners dispute that *Guice* is similar to this action, Pet. 16-17 & n. 6, an argument expressly rejected by the Appellate Division and implicitly rejected by the New York Court of Appeals when it determined that no substantial constitutional issue was directly presented in petitioners' unsuccessful effort to appeal to that court. (Pet. App. A26). *Guice* involved state common law claims relating to "payments for order flow", *i.e.*, allegedly undisclosed benefits obtained by broker-dealers in connection with execution of orders for customer accounts. Payments for order flow are the subject of SEC rules that require disclosure of payment for order flow practices on customer confirmations and account statements, as well as upon opening new accounts. *See Guice*, 89 N.Y. 2d at 39-43, 674 N.E. 2d at 286-88, 651 N.Y.S. 2d at 356-58. Although these regulations specify how and when information about brokers' receipt of payments for order flow is to be disclosed to customers, the SEC has refused either to ban the practice or to require brokers to pass the benefits of payments for order flow along to their customers. In light of this regulatory history, the New York Court of Appeals held that state law causes of action against two defendant broker-dealers for, *inter alia*, breach of fiduciary duty were preempted by the Supremacy Clause because they conflicted with federal law. The court reasoned:

> Permitting the courts of each State to impose civil liability on national securities brokerage firms . . .

> for failure to meet more stringent common-law agency standards of disclosure of receipt of order flow payments . . . would inevitably defeat that congressional purpose of enabling the SEC to develop and police that "coherent regulatory structure" for a national market system. Securities broker-dealers, confronted with the risk of nation-wide class action civil damage liability, including restitution of commissions and punitive damages . . . would be impelled to tailor their disclosures to each State's common law agency jurisprudence, and the carefully-crafted SEC disclosure requirements would have little, if any, influence. Surely "[i]t is unlikely — to say the least — that Congress intended to establish such a chaotic regulatory structure . . ."
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> * * *
>
> When, thus, a State's regulation, through the imposition of common-law tort liability or otherwise, adversely affects the ability of a Federal administrative agency to regulate comprehensively and with uniformity in accordance with the objectives of Congress, "then the state law may be pre-empted even though 'collision between the state and federal regulation may not be an inevitable consequence . . .' "

Guice, 89 N.Y. 2d at 46-47, 674 N.E. 2d at 290, 651 N.Y.S. 2d at 360 (citations and footnote omitted). This Court declined to review the New York Court of Appeals' decision. 117 S. Ct. 1250 (1997).[14]

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14. Petitioners claim that the order flow decisions do not control the result here because the order flow payments involved in

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The issues raised in this case are, in all material respects, virtually identical to those addressed in *Guice*. Here, as in *Guice*, the plaintiffs assert that defendant broker-dealers obtained unaccounted-for benefits from plaintiff's' securities accounts, which they did not pass along to their customers, allegedly in violation of state common law duties. Here, as in *Guice*, the claims purportedly extend to a nationwide class of plaintiffs and would effectively require all broker-dealers to conform their nationwide operations to state law standards. Here, as in *Guice*, the complaints seek monetary relief for the asserted breaches of fiduciary duty. Here, as in *Guice*, the complaint asserts claims based upon nondisclosure of matters of which the SEC does not mandate disclosure. *Compare Guice*, 89 N.Y. 2d at 38-39, 674 N.E. 2d at 285, 651 N.Y.S. 2d at 355 *with* Pet. App. A65-66 at ¶ 25-26. Here, as in *Guice*, the SEC has not prohibited the challenged practice but has sought to balance conflicting policy concerns by regulations through disclosure and other requirements. *See First Proposal of Rule 15c3-3*, 1971 WL 16389, at *6. Here, as in *Guice*, conformance to one or more state law standards would moot the SEC regulations by suppressing a practice explicitly found by the SEC to have important benefits to customers. *See Special Study*, at 393-401. Finally, here, as in *Guice*, the SEC has extensively studied and consistently adhered to its regulatory approach. Its regulation has, from the start, been premised on its finding that the

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those cases, unlike free credit balances, have been the subject of extensive study by the SEC. Pet. 16. This contention is rebutted by the legislative and regulatory history discussed earlier in this brief, establishing that both the SEC and Congress carefully studied, recognized the benefits of, and approved the use of free credit balances by broker-dealers without payments to customers. Moreover, under section 15(c)(3) of the Exchange Act, the SEC possesses pervasive authority to monitor the use of free credit balances by broker-dealers.

relationship of broker to customer in the handling of customer free credit balances is one of debtor-creditor, and thus the payment of interest on such balances is a matter of contract, not a matter of right. *See supra,* Point I.

Moreover, *Guice* stands as part of a consistent line of cases finding that the federal securities laws preempt certain state common law claims against broker-dealers where those claims are based on state law that is more restrictive than the carefully considered federal regulatory scheme. *See, e.g., Dumont v. Charles Schwab & Co.*, Nos. 96-C-2685 & 97-CA-1225 (La. Ct. App. 4th Cir. Apr. 8, 1998); *Orman v. Charles Schwab & Co.*, 688 N.E. 2d 620, 621, 625-26 (Ill. 1997), *petition for cert. filed* (Feb. 18, 1998) (No. 97-1367); *Shulick v. Paine Webber, Inc.*, 700 A.2d 534, 536, 538 (Pa. Super. Ct. 1997); *Eirman v. Olde Discount Corp.*, 697 So. 2d 865, 866 (Fla. Dist. Ct. App.), *certification denied*, (Fla. Aug. 28, 1997); *Dahl v. Charles Schwab & Co.*, 545 N.W. 2d 918 (Minn.), *cert. denied*, 117 S. Ct. 176 (1996).

III.

THE FACTS OF THIS LITIGATION ARE UNIQUE AND UNLIKELY TO RECUR.

Petitioners' claim that this case is of such great importance as to warrant this Court's review ignores the limited scope of the conflict in issue. The SEC's regulation of free credit balances preempts only a narrow subset of state law claims. The unimportance of these claims is borne out by the fact that only one other state court case has presented a conflict between the purported state law obligations of broker-dealers in handling free credit balances and the federal regulatory scheme and that case has been dismissed without appeal. *See In Re Prudential Secs., Inc. Sweep Litigation*, No. 122747/95 (N.Y. Sup. Ct.

N.Y. Cty. Jun. 24, 1997). (Resp. App. 20a).[15] And, petitioners' claims are in any event without merit.[16] Moreover, as noted

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15. Thus, certiorari should also be denied because the particular conflict between state and federal law presented by this case is unlikely to recur. It is entirely possible that, once this litigation is concluded, this issue will not be presented to any court any time soon. The progress of this litigation demonstrates why. Petitioners brought suit against eleven of the largest firms in the securities industry. As noted above, the class they sought to represent was inherently unwieldy and tremendously diverse in interests, and the particular practices at issue varied greatly by time, individual defendant, and type of transaction and account. The trial court's October 2, 1996 opinion denying the motion for class certification left grave doubts as to whether, under these circumstances, such a class could ever be certified. (Resp. App. 1a). Petitioners' claims would require the factfinder to unravel, at a minimum, virtually every securities transaction in petitioners' accounts throughout the applicable limitations period. Furthermore, as discussed below, there is no state law duty to pay interest or any other compensation for use of free credit balances; the relationship between a brokerage firm and its customers, when they choose to leave funds idle in their accounts, is that of debtor-creditor.

16. Petitioners' theory that a fiduciary relationship is created whenever a broker-dealer handles customer funds directly conflicts with controlling authority in New York regarding the limited circumstances in which broker-dealers owe fiduciary duties to their customers. Because almost every aspect of the ordinary customer-broker business involves the handling of customer assets, if petitioners' position were correct, a broker-dealer necessarily would owe a fiduciary duty to its customer virtually at all times. This is not the law; the New York courts have held that "a broker does not, in the ordinary course of business, owe a fiduciary duty" to a customer. *See, e.g., Perl v. Smith Barney Inc.*, 230 A.D.2d 664, 666, 646 N.Y.S.2d 678, 680 (N.Y.A.D. 1st Dep't), *appeal denied*, 89 N.Y.2d 803, 675 N.E.2d 1234, 653 N.Y.S.2d 281 (N.Y. 1996); *Fekety v. Gruntal & Co.*,

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above, the broader issue — the impact of Section 28(a) on state law claims that conflict with the Exchange Act — has been resolved with substantial uniformity by the lower courts. *See supra* Point II. Finally, the practices of which petitioners complain are of decreasing practical importance. Competition in the brokerage industry has increasingly led respondents and other broker-dealers to offer "sweep" accounts in which free credit balances are automatically invested in money market funds. Thus, the free market has provided a response, bearing out the wisdom of the SEC's insistence that payment of interest on free credit balances is "governed by contract between the parties." *Newman*, ¶ 78,177, at 80,545.

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191 A.D. 2d 370, 371, 595 N.Y.S.2d 190, 190-91 (N.Y.A.D. 1st Dep't 1993). *See also Press v. Chemical Inv. Servs.*, No. 96 Civ. 8331, 1997 WL 795100, *8-10 (S.D.N.Y. Dec. 22, 1997), and cases cited therein. This is consonant with "[t]he general [common law] rule . . . that a broker is not the fiduciary of his customer unless the customer entrusts him with discretion to select the customer's investments" *Carr v. CIGNA Secs.*, 95 F.3d 544, 547 (7th Cir. 1996) (Posner, C.J.). Similarly, petitioners' unjust enrichment theory is fatally flawed. The right to use funds (which petitioners do not challenge, *see* Pet. 2-3) implies the right to retain the earnings thereon, unless otherwise agreed. *See, e.g., Surrey Strathmore Corp. v. Dollar Sav. Bank*, 36 N.Y.2d 173, 177, 325 N.E.2d 527, 529-30, 366 N.Y.S.2d 107, 110-11 (1975) (permitting bank to retain benefits earned from using customer funds inasmuch as bank was authorized to use funds). Moreover, petitioners have not pleaded, nor can they, that any enrichment of respondents was at the "expense" of petitioners, *i.e.*, that any plaintiff has demanded access to his or her free credit balance and that the demand was rejected.

CONCLUSION

For the foregoing reasons, respondents respectfully request that this Court deny the petition for certiorari.

Respectfully submitted,

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April 10, 1998

APPENDIX A — MOTION AND MEMORANDUM OPINION OF THE SUPREME COURT OF THE STATE OF NEW YORK, NEW YORK COUNTY FILED OCTOBER 2, 1996

SUPREME COURT OF THE STATE OF NEW YORK — NEW YORK COUNTY

PRESENT: **Hon.** Charles E. Ramos **Part 53**
Justice

INDEX NO. 111667/94

MOTION DATE 7/30/96

MOTION SEQ. NO. 006

MOTION CAL. NO. 01

ESTATE OF DAVID J. BRAUNSTEIN, et al.

- v -

MERRILL LYNCH, PIERE, FENNER & SMITH, Inc., et al.

* * *

Cross-Motion: ☐ **Yes** ☑ **No**

Upon the foregoing papers, it is ordered that this motion for class certification is decided in accordance with the annexed memorandum.

Dated: 9/26/96

s/ Charles E. Ramos
J.S.C.

Appendix A

SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK: COMMERCIAL DIVISION

THE ESTATE OF DAVID J. BRAUNSTEIN and ROSEMARIE BRAUNSTEIN, et al.,

Plaintiffs,

- against -

MERRILL LYNCH, PIERCE, FENNER & SMITH INCORPORATED et al.,

Defendants.

CHARLES E. RAMOS, J:

This is an action by the customers of several major securities brokerage firms, challenging the control and use of "free credit balances" on their customers' investment accounts. Plaintiffs move, pursuant to CPLR §§ 901 and 902, for an order to certify the class action on their claims for common law breach of fiduciary duty and unjust enrichment.

THE FACTS

Plaintiffs are twelve Arizona residents[1] and customers of the defendants which do business or are headquartered in New York. Plaintiffs seek to represent a class consisting of:

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1. Several of the named plaintiffs originally filed this litigation in Arizona Superior Court on July 12, 1993. The case was then stayed on forum non convenience grounds by order dated November 1, 1993, in which the court held that New York was a more appropriate

(Cont'd)

Appendix A

> All persons or entities who have, or have had accounts with one or more of the defendants in which they have had free credit balances which existed overnight or longer from which the defendants have received economic benefits for which the defendants have not properly accounted to the plaintiffs. Excluded from the class are the defendants, all employees of the defendants and the members of their immediate families, the subsidiaries and affiliates of the defendants, any trusts of any entities which they control or of which they are the beneficiaries and the heirs, successors or assigns of any of the defendants.

(First Amended Complaint at p. 9). Free credit balances are cash balances in a customer's account which are otherwise unencumbered, and are subject to immediate cash payment to a customer on demand. Generally, they result from sales of securities, dividends, interest, or transfers of account balances from one broker to another, and may exist overnight or longer depending upon the type of transaction involved. Defendants use these balances to make loans to other customers at allegedly relatively high interest rates. At issue is whether defendants can profit from such use without paying to their customers any portion of the profits earned on the use of the customer's funds.

On June 7, 1995, Justice Walter Schackman of this court dismissed the complaint without prejudice for failure to plead a

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forum for the litigation. Further holding that "[s]hould the New York court impose any substantial impediment to or limitation upon that litigation which this court would not impose," the court would consider vacating the stay and denying the defendants' motion to dismiss. (Plaintiffs' Notice of Motion, Second Ex. A, p.8).

breach of fiduciary duty and unjust enrichment with the requisite particularity under CPLR § 3016(b). In his ruling, he found that broker-dealers are permitted to use free credit balances for their own purposes, under Securities Exchange Rule 15c3-2 and 15c3-3, and that "to the extent that the balances are thus used, they are not being misused; there has been no breach of trust." (J. Schackman's Order, 6/7/95 at p. 3).

Plaintiffs then served the amended complaint which alleges that the defendants have adopted methods and procedures to use free credit balances which have been unnecessarily created or left in customers' accounts for longer periods than necessary. It further alleges that defendants have failed to adequately disclose, or account to plaintiffs for profits earned from the use of their balances. Plaintiffs seek restitution of any profit earned by defendants, an accounting, and injunctive relief.

The amended complaint was upheld by Justice Schackman in his order dated May 7, 1996. Therein, he states that: "the relationship between a stockbroker and its customer . . . is that of principal and agent and, thus, is fiduciary in nature." In quoting *Greenwald v. Shearson Lehman Brothers, Inc.*, (NYLJ, Nov 4, 1993, at 22, col.3 [Sup Ct, NY County]), he also states that:

> Whenever the broker is acting as the agent of the customer, for example, in executing a customer's order or handling customer funds, the customer has the right to assume and to rely on the fact that the broker is acting for his or her benefit at all times during the relationship. (Cite omitted).

(Decision, at p. 3; citing *Evangelist v. Fidelity Brokerage Services, Inc.*, __ AD2d __, 637 NYS2d 392 [1st Dept 1996]

Appendix A

[reversing dismissal of class action complaint against securities broker alleging breach of fiduciary duty resulting from failure to disclose practice of receiving order flow payments from market makers as inducement for placing orders with them]; *Feinberg v. Dean Witter Reynolds*, Sup Ct, NY County, August 14, 1992, Arber, J., Index No. 11868/92 [fiduciary duty may exist regarding undisclosed $50 service charge on brokerage accounts]).

CPLR ARTICLE 9

Under CPLR § 901(a), one or more members of a class may sue or be sued as representative parties on behalf of all if:

1) the class is so numerous that joinder of all members, whether otherwise required or permitted, is impracticable;

2) there are questions of law or fact common to the class which predominate over any question affecting only individual members;

3) the claims or defenses of the representative parties are typical of the claims or defenses of the class;

4) the representative parties will fairly and adequately protect the interest of the class; and

5) a class action is superior to other available methods for the fair and efficient adjudication of the controversy.

Appendix A

The goal of the class action device is to "achieve economics of time, effort, and expense, and promote uniformity of decision as to persons similarly situated". (*Sanders v. Robinson Humphrey/American Express, Inc.*, 634 F Supp 1048, 1054; *Friar v. Vanguard Holding Corp.*, 78 AD2d 83, 91 [2nd Dept. 1980]). The movant bears the burden of proving that all of the prerequisites of CPLR § 90 (a) have been met, which must be shown by offering more than mere conclusory allegations. (*Katz v. NVF*, 100 AD2d 470, [1st Dept. 1984]; *Brandon v. Chefetz*, 121 Misc.2d 54, 56 [1st Dept 1983]). It is not until all of the prerequisites of § 901 (a) have been met that the court can consider CPLR § 902 which sets forth five illustrative guidelines for the court to determine the viability of a class action. Whether, or not, to certify a class is within the court's discretion. However, the statute should be liberally construed, since the state's policy is in favor of maintenance of class actions. (*Brandon v. Chefetz*, 106 AD2d 162 [1st Dept. 1985]). Because Article 9 of the CPLR is modeled on Rule 23 of the Federal Rules of Civil Procedure, New York courts have looked to interpretations of Rule 23 for guidance. (*Stern v. Carter*, 82 AD2d 321 [2nd Dept 1978]; 2 Weinstein-Korn-Miller, NY Civ Prac ¶ 901.02).

FINDINGS

In applying the criteria of CPLR § 901(a), the court finds that while the class is sufficiently numerous, class action is not currently warranted. Because plaintiffs have not shown a common course of conduct in the mishandling of accounts, class certification must be denied as to this aspect of the complaint. Breach of a duty to disclose and the claim for unjust enrichment are commonly based upon similar facts. However, under the remaining criteria, plaintiffs have failed to demonstrate that there are common issues of law, a typicality of claims and

practices of the various defendants that allegedly give rise to those claims, and that the plaintiffs can adequately represent the class. On this record, the court also cannot find that a class action is a superior method, and therefore, the motion for class certification is denied without prejudice to renew.

DISCUSSION

The number of potential class members in this proposed nation-wide class action lies somewhere in the millions. Plaintiffs need not specify an exact number of class members, but must show only that joinder is impracticable through "some evidence or reasonable estimate of the number of purported class members." (*Zeidman v. J. Ray McDermott & Co.*, 651 F2d 1030, 1038 [5th Cir. 1981]). Defendants have indicated that they maintained a total of approximately 23,600,000 accounts, in 1993, on which approximately 1,170,000 transfers occurred. None of them contend that the plaintiffs have not met the numerosity requirement, and thus, this court finds that the first prerequisite of CPLR § 901(a) has been satisfied.

Defendants essentially oppose class certification on the grounds that common questions do not predominate. They allege that a trial will require examination of: each of the defendants' various types of customer accounts; the policies and procedures of each defendant for handling their accounts; the various type of transactions creating free credit balances; the identity of those portions actually used; the timing of the availability of each free credit balance; and the amount by which each defendant has benefitted. (Def. Memo. p. 24-32).

Defendants also contend that common issues do not predominate because individual issues will be raised since class

members reside throughout the United States and in some foreign jurisdictions, and thus, the court will have to apply the laws of all fifty states. Some customers have signed account customer agreements which contain choice of law provisons. Defendants allege that the court will have to apply the laws of at least three states, and perform a conflict of laws analysis for those class members who have not signed an agreement. Thus, they conclude that a case of this magnitude is unmanageable, and therefore, class certification should be denied.

Commonality is established, under CPLR § 901 (a) (2), when the activity complained of involves one set of operative facts from which plaintiffs' claims arise. (*Green v. Wolf*, 406 F2d 291, 299-300 [2d Cir. 1968], *cert denied*, 395 US 977 [1969]; *Friar v. Vanguard Holding Corp.*, *supra* 78 AD2d at 99). "It is unnecessary that every question be common to each member of the class; all that is required is that common questions predominate over individual ones." (*Gilman v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 93 Misc.2d 941, 947 [Sup. Ct. NY County 1978]). Generally, the courts focus on the liability issue in deciding whether the predominance requirement has been met, and if the liability issue is common to the class, common questions are held to predominate over individual questions. (*Dura-Bilt Corp. v. Chase Manhattan Corp.*, 89 FRD 87, 93 [SD NY 1981] *citing, Sargent v. Genesco Inc.*, 75 FRD 79 [M.D. Fla. 1977]; *Brady v. Lac Inc.*, 72 FRD 22 [SD NY 1976]).

Some courts have held that commonality is satisfied when the plaintiffs' complaint centers on the defendants having engaged in a common course of conduct, or a common core of facts which clearly links the class members to the resolution of the litigation even though the individuals are not identically

situated. (Weinstein-Korn-Miller, NY Civ Prac ¶ 901.11). On this basis, commonality can be inferred until it is proven at trial that the plaintiffs and all class member are similarly situated. (*See, Brandon v. Chefetz, supra* 106 AD2d at 167 [granting class certification where defendant participated in a common scheme by using long term compensation agreements to misappropriate portions of the shareholders' profits]; *Stellema v. Vantage Press, Inc*, 121 Misc.2d 1058 [Sup Ct NY County 1983], *aff'd in part, mfd in part*, 109 AD2d 423 [1st Dept 1985] [finding the representations were uniform and generally transmitted in two documents]; *Green v. Wolf Corporation, supra* 406 F2d 291 [granting class certification where the defendants' misrepresentations in three prospectuses comprised a common course of conduct]; *In re Lilco Securities Litigation*, 111 FRD 663 [ED NY 1986] [finding a common course of conduct after defendants failed to disclose material information in written documents "addressed to the class as a whole[.]"; *Vulcan Society of Westchester County v. Fire Dept. Of City of White Plains*, 82 FRD 379 [SD NY 1979] [finding four defendant municipalities had engaged in a common course of conduct by using the same written examination purportedly to further their discriminatory hiring practices]; *Roberts v. Heim*, 670 F Supp 1466 [ND Cal 1987], *aff'd in part mdfd in part*, 857 F2d 646 [finding a course of conduct based upon an alleged conspiracy]).

Some courts, however, have declined to find a common course of conduct. (*See, Sanders v. Robinson Humphrey/ American Express, Inc., supra*, 634 F.Supp 1048 [ND Ga 1986] [finding that there was no proof of a uniform "sale pitch" by the defendants to all the members of the proposed classes]; *In re Scientific Control Corp. Securities Lit.*, 80 FRD 237 [SD NY 1978] [rejecting, as against certain defendants, allegations of a common course of conduct where there was no proof that

they used misleading written financial statements]; *Evans v. City of Johnstown*, 97 AD2d 1 [3d Dept 1983] [denying class action for personal injury claims arising from operation of sewage plant because individual issues of causation and damages are particular to each plaintiff]; *See, also Castano v. American Tobacco Company*, 84 F3d 734 [5th Cir 1996] and *In re American Medical Systems, Inc.*, 75 F3d 1069 [6th Cir 1996] [no common course of conduct in mass products liability or negligence cases because proof will vary from plaintiff to plaintiff on the issue of causation.])

Two distinct breaches of fiduciary duty have been alleged in the complaint: 1) a failure to disclose, and 2) a mishandling of customers' accounts. (Amended Complaint, p. 12 at ¶ 20). A common course of conduct in breach of a duty to disclose will, if proven at trial, support all of the class members' claims. However, no common core set of facts have been shown which would support the allegation that all accounts have been similarly mishandled.

Regardless of the type of account, no lesser duty is owed to a stockbroker's customer than the duty to disclose any material information regarding the account (*See, Richardson v. Shaw* 209 US 365 [1908]). Once a transaction is made and until its completion, or where there has been a reposing of trust, the same duty is owed to all account holders. (*See, Le Marchant v. Moore*, 150 NY 209 [1896]; *Hopkins v. Clarke*, 158 NY 299 [1899]). Plaintiffs have alleged that each defendant unilaterally controls a customer's free credit balances, and therefore, all customers have reposed a similar type of trust. On this issue, defendants have not shown that individual questions predominate, because, arguably, a duty may attach to any customer's account where a free credit balance exists. For

example, if free credit balances are found to occur prior to the end of a transaction, or are within a broker's exclusive control, it may be found a duty is owed until the transaction is complete, and until the balance is no longer "free". Therefore, proof of a duty to disclose need not depend on individual facts particular to each class members' account.

Similar to the cases cited above, common questions will predominate on this issue because each member may have claims against the defendants for omitting this information from their customers' written account statements. In breach of their duty, plaintiffs have alleged that each defendant sends to all customers an account statement which fails to disclose the dollar amount of existing free credit balances, and that their customers will not receive any of the benefits earned. (Amended Complaint, p. 14 at ¶ 24). Although defendants admit that a customer has a right to withdraw their free credit balances on demand, it has been asserted that "a client [can] not tell specifically [from the account statements] whether his balance is a free credit balance or not". (Dolan Deposition, at p. 38 [2]-41[13]). Thus, the wrong complained of may be identical for each of the class members. Similarly, the several defenses that have been raised are available against all class members.

This court is unpersuaded by defendants' contention that plaintiffs will have to prove that each class member lacks knowledge of the "longstanding industry-wide practice" not to pay customers part the benefits earned. Because the members' claims are based upon the failure to disclose the amount of the balances, the defendants, not the plaintiffs, may be required to prove that adequate notice was given. The defendants' assertion that a notice appearing on the reverse-side of the account statements adequately discloses to the customer "the right to

use" and "the customers' right to withdraw such balances on demand" is dispositive on this issue is premature. (Def. Memo. p. 28 and 39). They argue individual issues will predominate in raising their defenses because notice, waiver, and estoppel all require proof that each class members knew about the use of the balances, knowingly relinquished their right to any benefits earned, and thereby, caused them to rely upon a customer's actual or implied consent. While certain class members may be more sophisticated or knowledgeable than others about the use of free credit balances, those facts are not so particular to individual class members that subclasses cannot be created to address this problem. Inferences can be drawn from the defendants' written notice, therefore, it may be implied, as to certain class members, that they knew or should have known about the use of free credit balances. (*Derenco, Inc. v. Benj. Franklin Federal Savings & Loan Assn., supra* 577 P.2d 477 [Sup Ct Oregon, 1977]). Whatever differences do exist with regard to actual knowledge, these can be proven at the same time as individual damages are proven. (*Compare, Stellema v. Vantage Press, supra* 109 AD2d at 426). Thus, this is not a basis for denying class certification on the issue of liability. (*Ray v. Marine Midland Grace Trust,* 35 NY2d 146, 154 [1974]; *Dura-Bilt Corp. v. Chase Manhattan Corp., supra*, 89 FRD 87 [SD NY 1981]).

Based upon these allegations, it may or may not be found that plaintiffs have a quasi-contract right to an accounting for the benefits earned. The circumstances surrounding the parties' relationship will no doubt encompass a duty to disclose, and if the failure to disclose is found to unjustly enrich the defendants, then plaintiffs and the class members may be entitled to equitable or monetary relief. (*See, Derenco, Inc. v. Benj. Franklin Federal Savings & Loan Assn., supra* 577 P.2d 477 [Sup Ct Oregon, 1977]).

Appendix A

On the question of damages, individual issues clearly predominate over common issues. Since if damages are found, a determination may depend upon the amount of free credit balances existing on an account, whether the balances were used, or the members' type of account. However, this is no reason to deny class certification because under such circumstances the court has the authority to order a bifurcated trial with respect to liability and damages. (*Friar v. Vanguard Holding Corp., supra* 78 AD2d at 99).

As to the second aspect of the claim for breach of duty, plaintiffs have failed to show that a *common* "method and procedure" was adopted by the defendants whereby free credit balances were unnecessarily created, delayed or retained. (Amended Complaint, p. 12 at ¶ 20). Each of the eleven defendants' policies and procedures for handling its customers' accounts will have to be examined in order for plaintiffs to prove their claim. By their very nature, no two free credit balances appear to be the same, and they can be created through any number of methods. Whether or not they were improperly handled by defendants will depend on proof that each type account imposes a similar duty, and that each type of transaction free credit balances were unlawfully retained on a customer's account. On each type, it will have to be proven that a free credit balance existing overnight or longer has been unnecessary delayed or retained.

There is no common overriding standard or common set of facts which will allow this determination to be made other than on a case by case basis, and this court cannot envision how separate individualized trials will not ensue. Plaintiffs do not propose how they plan to manage a trial on this aspect of their claims. Their conclusory statement that subclasses may be

created, ignores the very real possibility that a trial on this issue is likely to splinter into separate "mini-trials" in hope of resolving these individual issues. Therefore, the court finds that separate trials must be had, since class certification is not appropriate as to this aspect of members' claims.

On the questions of law, plaintiffs allege that this court should not focus on the class and their contacts to this and other states because New York law will apply to all class members' claims based upon defendants contacts to New York, and this state's interest in the securities industry. The parties also dispute who should bear the burden of showing whether significant differences exist in the substantive law of the several states.

In *Phillips Petroleum Co. v. Shutts*, (472 US 797 [1985]) the Supreme Court held that Kansas could not apply its own law in a nationwide class action involving a failure to make royalty payments on natural gas leases. The leased land was located in eleven states and the three named plaintiffs resided in Kansas or Oklahoma and owned leases in Texas and Oklahoma. The Court held that a state court "may not take a transaction with little or no relationship to the forum and apply the law of the forum in order to satisfy the procedural requirement that there be a 'common question of law' ". (*Id.* at 821). Constitutionally, a state court must have "significant aggregation of contacts", or "contacts creating state interests" to the claims asserted by each member of the plaintiff class for the forum to apply its laws. (*Id.* at p. 821).

While *Castano v. American Tobacco Company, supra*, involves a nation-wide products liability class action and the facts are distinguishable from the present case, the Fifth Circuit's

discussion on variations in state law is instructive. The court found that the class action movant has the burden of proof to show the variations in state law when a class action involves multiple jurisdictions (at p. 742). Citing *Walsh v. Ford Motors Co.* (807 F.2d 1000, 1017 [DC Cir 1986], *cert. denied*, 482 US 915 [1987]), the court noted it cannot accept plaintiffs' assertion "on faith" that there is no variation in state laws, and that "through an extensive analysis" of state law variances is needed. (*Id.*).

These cases are consistent with New York's choice-of-law principles, and the burdens of proof under CPLR § 901(a). Much like the test in *Shutts*, New York courts apply the laws of the state having the most significant contacts with the occurrence and with the parties. (*Babcock v. Jackson*, 12 NY2d 473, 482 [1963]; *Auten v. Auten*, 308 NY 155, 160 [1954]). As previously stated, CPLR § 901 (a) places the burden on the movant to show that its prerequisites have been met, (*Infra*, at p. 4), and to establish the identity of the class. (*Gottlieb v. March Shipping Passenger Servs.*, 67 AD2d 879 [1st Dept 1979]; *See also Katz v. NVF Co.*, *supra* 100 AD2d at 474; *Bloom v. Cunard Line Ltd.*, 76 AD2d 237, 240 [1st Dept 1980]). Not discounting that New York is arguably the financial capital of the United States, and where defendants do all or most of their business; plaintiffs' papers fail to support their own allegations that New York has significant contacts to *the class members' claims*.

As was recognized by plaintiffs, the contacts which must exist should be distinguished given that this case is for breach of fiduciary duty case, and is not a securities case. (Arizona Papers). Plaintiffs knew of 425,000 accounts existing in Arizona, and had some information about where defendants

transact their business on their customers accounts. However, instead of establishing the members' contacts, or where the claims accrued, they offer the defendants' papers submitted on their Arizona motion to dismiss for forum non convenience, where the focus was on the defendants and their contacts outside of the forum state. This does not demonstrates how these contacts connect to the class members and their claims.

Plaintiffs have admitted that "the same conflict of law issues would still need to be addressed . . . . by the court analyzing and applying the law of various jurisdictions[.]" (Pl. Resp. Motion to Dismiss, p. 8). Four state laws (New York, Maryland, Illinois, and California) have been identified in the choice of law provisions; and three other states are mentioned as where some of defendants' facilities are located. In this case, the court sees no reason why plaintiffs should not bear the burden of showing through a thorough conflict of law analysis that common questions of law predominate. Plaintiffs cite a single federal decision stating that there are no variations of state laws on breach of fiduciary duty, a couple of cases on unjust enrichment, and none of the states' applicable statutes of limitation. They have failed to substantially identify the legal issues under the state laws which may apply. In absence of such a record, this court cannot decide whether or not it is arbitrary or unfair to override the contract provisions, or whether New York law may apply to all claims. Therefore, plaintiffs have not shown that common questions of law predominate.

The typicality requirement of CPLR § 901 (a) (2) has not been satisfied because plaintiffs have not shown that their claims arise from a common course of conduct *and* that common questions of law predominate. (*See, Friar v. Vanguard Holding Corp., supra* 78 AD2d at 99; 2 Weinstein-Korn-Miller NY Civ

Prac ¶ 901.14). As was discussed above, while the claims are derived from the same course of conduct by the defendants, they have failed to show that New York's substantive law will be used in determining the rights of class members. (*Bittner v. Metropolitan life Ins. Co.*, NYLJ p. 27 col 6, J. Gammerman 12/19/94). Therefore, on this record, the court cannot find that their claims are substantially similar so as to satisfy the typicality requirement (*Compare, Weinberg, v. Hertz Corp.*, 116 AD2d 1 [1st Dept 1986]; *Brandon v. Chefetz, supra*, 106 AD2d 162 [1st Dept 1985]).

The adequacy of representation, under CPLR § 901 (a) (4), requires: (1) the representative plaintiffs will fairly and adequately protect the interests of the class — that is they are familiar with their claims and that they do not have substantial interests that are antagonistic to or conflict with those of the members of the class — and (2) the attorney for the class is qualified, experienced and generally able to conduct the litigation. (*In re Lilco Securities Litigation, supra*, 111 FRD at 672 [Ed NY 1986]; *Dura-Bilt Corp. v. Chase Manhattan Corp., supra*, 89 FRD at 102 [SD NY 1981]).

As plaintiffs correctly note, it is not required that they have any significant understanding of the legal or factual basis on which a complex case rests in order to maintain a class action. (*Dura-Bilt Corp. v. Chase Manhattan Corp., supra*). They must demonstrate a sufficient understanding of the nature of the case in order to vigorously pursue the prosecution of the litigation. Plaintiffs have shown that they have a basic understanding of the nature of this case and the financial resources to prosecute the litigation. However, plaintiffs' counsel's conclusory allegation that the named plaintiffs share substantially the same interests with that of the absent class members, without having

addressed whether their interests are consistent with those "entities" that they seek to represent is suspect at best.

Counsel for the plaintiffs have not made it at all clear who they seek to represent. That the class members are all account holder's and the customer of defendants is no basis on which this court can determine whether or not their interests are consistent. If these "entities" are institutional investors, their decision-makers may be influenced by considerations that would not affect individuals, or reach decisions which may be the product of an internal corporate compromise, and thus, what may be in the best interest of individuals may not be so for the corporate class members. (*See, In re Lilco Securities Litigation, supra; Hansberry v. Lee*, 311 US 32, 42 [1940]). But this is based purely speculation, since plaintiffs have failed to identify or describe how the class members' interests are consistent. Therefore, at this juncture, the court cannot find that plaintiffs have satisfied this requirement or shown that a class action is the superior method in reaching a disposition on theses claims.

Although plaintiffs allege, without demonstrating, that the class members' claims are small, it is conceivable that large entities, such as institutional investors may have sizeable claims. Again, plaintiffs' conclusory allegations do not address whether, in such event, the "economic reality dictates that [this] suit proceed as a class action at all . . . [because] the maximum damages recoverable by any single plaintiff [or class member] would be hardly enough to enable [it] to conduct to completion the protracted and complicated litigation to establish [its] claim." [cite omitted]. (*Gilman v. Merrill Lynch, Pierce, Fenner & Smith, supra*, 93 Misc.2d at 948).

Based upon the forgoing, this court finds plaintiffs have not satisfied all of the prerequisites of CPLR § 901(a). Depending on the facts developed, the plaintiffs may renew this motion, after appropriate discovery. Accordingly, plaintiffs' motion for class certification is denied without prejudice to renew.

The forgoing constitutes the decision and order of the court.

Dated: Sept. 26, 1996

ENTER

s/ Charles E. Ramos
J.S.C.

APPENDIX B — MOTION AND MEMORANDUM DECISION OF THE SUPREME COURT OF THE STATE OF NEW YORK, NEW YORK COUNTY IN *SANDRA BALLAN v. PRUDENTIAL SECURITIES, INC.* FILED JUNE 24, 1997

SUPREME COURT OF THE STATE OF NEW YORK — NEW YORK COUNTY

PRESENT: **Hon.** Herman Cahn ***Justice*** **PART 49**

INDEX NO. 122747/95

MOTION DATE 3/10/97

MOTION SEQ. NO. 002

MOTION CAL. NO. 3

SANDRA BALLAN

- v -

PRUDENTIAL SECURITIES, INC.

* * *

Upon the foregoing papers, it is ordered that this motion

[stamp] MOTION IS DECIDED IN ACCORDANCE WITH ACCOMPANYING MEMORANDUM DECISION IN MOTION SEQUENCE . . . . . .

Dated: 6/18/97

s/ Herman Kahn
J.S.C.

Check one: ☑ **FINAL DISPOSITION**
☐ **NON-FINAL DISPOSITION**

Appendix B

SUPREME COURT: NEW YORK COUNTY
IAS: PART 49

IN RE

PRUDENTIAL SECURITIES INC.
SWEEP LITIGATION

Index No. 122747/95

Seq. No. 002

CAHN, J:

This consolidated action arises from the alleged unlawful conduct of defendant Prudential Securities, Inc. ("Prudential") with respect to monies and free credit balances purportedly withheld from its customers for unduly long periods of time. Prudential moves for an order, pursuant to CPLR 3211(a) (1) and (7), 3013 and 3016(b), dismissing the complaint based upon documentary evidence, failure to state a cause of action, and failure to plead fraud with sufficient particularity. In addition, Prudential contends that a recent decision of the Appellate Division, First Department, entitled *The Estate of Braunstein v. Merrill Lynch, Pierce, Fenner and Smith, Inc.*, __ Ad2d __ [1st Dept. 1997], 657 NYS2d 12), which holds that state law claims against broker-dealers based upon their use of customer free credit balances are preempted by federal securities regulations, mandates the dismissal of plaintiffs' action.

In the securities industry, free credit balances are customers' funds held by brokerage firms which are subject to immediate cash payment to customers on demand, generally resulting from

sales of securities, dividends, interest, or other transaction. A "sweep" is generally the transfer of idle cash balances in customers' accounts into short-term income-generating investment vehicles such as money funds or bank short-term collective investment funds. In this action, plaintiffs claim that Prudential engaged in a practice of delaying the transfer of plaintiffs' free credit balances into money market funds for its own profit, and that such conduct constitutes an unjust enrichment, a breach of fiduciary duty, and a breach of the duty of good faith and fair dealing implied under its customer contracts.

On plaintiffs' own admission the only meaningful difference between this case and *Braunstein is* that here plaintiffs only sue one brokerage firm and in *Braunstein* plaintiffs sued several. The wrongs alleged in both cases are exactly the same. Therefore, *Braunstein is* determinative here, and plaintiffs' state claims are preempted by federal law. (See also, *Guice v. Charles Schwab* & Co., 89 NY2d 31 ([1996]).

In light of the foregoing the court need not and does not address that branch of defendant's motion to dismiss the complaint on state law grounds.

ORDERED that defendant's motion to dismiss is granted, and it is further

ORDERED that the Clerk is directed to enter judgment accordingly.

Dated: June 18, 1997

s/ Herman Cahn
J.S.C.